WEST COAST RESOLUTION GROUP

CRITICAL INSOLVENCY ISSUES PRESENTED IN MEDIATING UNINSURED OR UNDER-INSURED DISPUTES

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I. INTRODUCTION.

While the lion's share of the effort in most mediations is expended in attempting to find the "magic number" upon which the adverse parties can agree, in situations where the dispute is either uninsured or under-insured, there are critical insolvency issues which should be considered by the parties in that failure do so may make any settlement achieved illusory or, worse, the settlement may put one of the parties in an inferior position than if no settlement was achieved in the first place. Sadly, consideration of these issues is often totally overlooked in many mediations.

This Article will provide an overview from both the plaintiff's and the defendant's perspectives regarding (1) the potential avoidability of transfers to the plaintiff made pursuant to the settlement and any liens against the defendant's property which may have been obtained by the plaintiff in the underlying litigation leading up to the mediation; (2) actual or implied threats made by the defendant during the mediation of an insolvency proceeding of some type; and (3) the potential non dis - chargeability of all or some of the plaintiff's claims should the defendant subsequently file a bankruptcy proceeding.

In any uninsured or under-insured dispute, the reasons the defendant is not willing to pay the plaintiff's demands are usually (1) because the defendant believes the plaintiff's claims are defensible and/or (2) because the defendant is simply unable to do so because of the defendant's financial condition. During the

course of the underlying litigation, the defendant will usually be quite vocal regarding his defenses but far less so regarding his financial condition. This Article will assume that there is little or no dispute as to the amount of the plaintiff's claims and, therefore, will address only the second reason in each of these areas. Also, for purposes of brevity, this Article will assume that the defendant is an individual rather than, for example, a corporation or partnership, although relief under the Bankruptcy Code would be available to such entities.

II. THE POTENTIAL AVOIDABILITY OF TRANSFERS TO THE PLAINTIFF MADE PURSUANT TO A SETTLEMENT AND ANY LIENS OBTAINED BY THE PLAINTIFF IN THE UNDERLYING LITIGATION LEADING UP TO THE SETTLEMENT.

Generally, if the defendant commences a bankruptcy proceeding (whether it be under Bankruptcy Code Chapters 7 (a liquidation), 11 (a reorganization), 12 (a family farmer or fisherman's debt adjustment) or 13 (an individual with regular income debt adjustment) within 90 days of the receipt of (1) a transfer of property by the defendant to the plaintiff; (2) to pay in whole or in part an existing claim against the defendant; and (3) which would enable the plaintiff to receive a greater portion of his claim than other creditors of the defendant who did not receive such a transfer, the transfer may be subject to avoidance in the bankruptcy proceeding and the plaintiff compelled to return what was transferred to the defendant's bankruptcy estate. If the plaintiff is what is known as an "insider" of the defendant, then the look-back period is increased from 90 days to one year. (11 U.S.C. § 547.) The same analysis would apply to the avoidability of any liens on the defendant's property the plaintiff may have obtained in the underlying litigation (Id.) and any prepetition contract (such as a settlement agreement) may be rejected giving rise to only a general unsecured claim by the plaintiff against the defendant's bankruptcy estate. (11 U.S.C. § 365.)

Therefore, if the plaintiff has any realistic reason to believe that the defendant may be insolvent (including the defendant himself actually informing the plaintiff that he is insolvent), the parties should consider the following:

From the plaintiff's perspective:

a. The plaintiff should attempt to negotiate provisions in the settlement agreement which would (1) allow the plaintiff to treat the settlement agreement as a nullity if a bankruptcy proceeding is commenced by or against the defendant within the preference period and (2) allow the underlying litigation to remain open until the settlement consideration has actually been paid and the relevant preference period has expired. That way, the plaintiff will not be bargaining away its claims in exchange for a mere promise to pay. Rather, the plaintiff's position should be that the settlement should, if possible, be structured as an "accord and satisfaction" so that the debt will not be satisfied until the preference period has expired after the transfer without such a bankruptcy proceeding having been commenced; and

b. The plaintiff should attempt to negotiate (1) the collateralization of the settlement commitment with property of the defendant which is otherwise unencumbered; (2) the provision by the defendant of a balance sheet under penalty of perjury as to solvency which would constitute a representation and warranty in the settlement agreement that would survive payment under the settlement agreement; and/or (3) the defendant will have the settlement commitment guaranteed and/or otherwise collateralized by some third person or entity. In this regard, the plaintiff's position should be, in substance, that "now that the parties have finally settled on an amount, their only concern should be that it somehow actually gets paid and that there will be no further litigation on account of the claims."

From the defendant's perspective:

a. The defendant should attempt to settle the plaintiff's claims in the simplest fashion possible without any additional "bells and whistles" such as an accord and satisfaction and that if that is

what the plaintiff insists upon, then a greater discount on the claims should be required. Defendant's position should be, in substance, that "assuming the matter actually went to trial in the underlying litigation, the plaintiff would not be able to receive any of the things he is requesting – only a judgment"; and

b. For the same reason the defendant should resist increasing the scope of the plaintiff's claims beyond those individuals or entities who are actually at risk in the underlying litigation. In this regard, the defendant's position should be, in substance, that "the plaintiff should take whatever payment it can get at this point given the defendant's economic realities and that the plaintiff should be satisfied with having received something which is better treatment than the defendant's other creditors."

III. ACTUAL OR IMPLIED THREATS MADE BY THE DEFENDANT DURING THE COURSE OF THE MEDIATION THAT HE WILL COMMENCE AN INSOLVENCY PROCEEDING OF SOME TYPE.

It is not uncommon in a mediation that a defendant will threaten to file a bankruptcy proceeding of some sort or an assignment for the benefit of creditors under California law as a negotiating ploy to compel the plaintiff to accept a smaller settlement. As noted in Section II, above, there are several Chapters under the Bankruptcy Code under which a defendant could seek protection of the bankruptcy court some of which (Chapters 12 and 13) have significant limitations. So, again in the interest of brevity, the discussion in this Article will be limited to Chapter 7 (a liquidation) and Chapter 11 (a reorganization) and will not discuss Chapters 12 or 13 or an assignment for the benefit of creditors. Because the threat of the commencement of a bankruptcy proceeding is usually made by the defendant, this

Article will discuss this issue from the defendant's perspective first. Here is what the parties should consider:

From the defendant's perspective:

a. **A threat by the defendant that he will file a Chapter 7 proceeding:** While filing a Chapter 7 proceeding is relatively affordable in that the retention of only one professional is normally required, the net effect of such a proceeding is that the debtor gets to keep only his exempt property (if there is any) with all of the defendant's other assets under the control of an independent Chapter 7 trustee who will determine how they are going to be administered with the defendant retaining only a "right to be heard" similar to any other creditor of the defendant's estate. In other words, other than exempt property, the defendant will suffer a total loss of control of his estate with the Chapter 7 trustee being totally in control. It is not uncommon that creditors will receive only pennies on the dollar or worse in a Chapter 7 proceeding after the expenses of administration are deducted. Thus, such a threat by a defendant to file a Chapter 7 proceeding can reasonably be described as a "doomsday" threat where the defendant's position should be, in substance, that "if the plaintiff does not do it the defendant's way, he will sink the entire ship and no one (specifically including the plaintiff) will receive anything." The use of such a threat in a mediation context is aimed at coercing the plaintiff to accept anything it can get in order to settle the litigation. It is a classic game of "chicken" by the parties and, as noted below, can backfire on the defendant; and

b. **A threat by the defendant that he will file a Chapter 11 proceeding:** The primary differences between a Chapter 7 proceeding and a Chapter 11 proceeding is that a Chapter 11 proceeding is a reorganization rather than a liquidation and the defendant will, at least initially, be in control of his bankruptcy estate as debtor in possession, subject to the supervision of the bankruptcy court. However,

the defendant's control over his bankruptcy estate is always subject to the potential for the appointment of a Chapter 11 trustee (which would result in the loss of control by the defendant), a conversion of the case to one under Chapter 7 or an outright dismissal. Further, a Chapter 11 proceeding is usually extremely expensive in that the employment of multiple professionals is normally required. Thus, a threat by a defendant to file a Chapter 11 proceeding is a bit more nuanced than the Chapter 7 "doomsday" threat where, in substance, the defendant's position should be that "he will reorganize in a Chapter 11 which will allow him to keep his property and at the same time radically affect the amount of the plaintiff's claim. So, the plaintiff is better off taking what the defendant is offering now rather than being put through this process."

From the plaintiff's perspective:

a. A threat by the defendant that he will file a Chapter 7 proceeding: A sophisticated plaintiff will normally understand everything that a defendant understands from his perspective as set forth above and, in addition, will understand that, like a riptide, a bankruptcy proceeding is easy to get into and hard to get out of. How much weight the plaintiff should accord such a threat is obviously case specific. Additionally, where, as here, the defendant is an individual, he may not qualify as a Chapter 7 debtor under what is known as the "means test" which sets limits on the amount of income an individual Chapter 7 debtor may have. (11 U.S.C. § 707.) In reaction to the threat, if the plaintiff invites the defendant to do it and get it over with, the defendant's resolve will then be tested and will often lead to a breaking down of an impasse in negotiations. In substance, what the plaintiff's position should be is that "he is tired of hearing the defendant talk about it so that if he is serious, he should go ahead and do it so the plaintiff can get it over with";

b. **A threat by the defendant that he will file a Chapter 11 proceeding:** Again, a sophisticated plaintiff will normally understand everything that the defendant understands from his perspective as set forth above. Because of the very high cost of a Chapter 11 proceeding, whether such a proceeding is actually available to the defendant will depend on whether the defendant has either substantial unencumbered cash or unencumbered other assets from which cash could be derived during the course of the Chapter 11 proceeding, Without either of these things, the plaintiff will likely understand that the defendant's threat to file a Chapter 11 is either hollow or ill advised; and

c. **A threat by the plaintiff that he will file an involuntary petition against the defendant (either under Chapter 7 or 11):** While an involuntary Chapter 7 or 11 proceeding could be filed by the plaintiff against the defendant (11 U.S.C. § 303) which the defendant may find unnerving, in reality it is normally considered to be a very bad idea for a plaintiff to do so because all the plaintiff would be doing is championing the rights of the defendant's other creditors while at the same time exposing himself to substantial liability. Exceptional circumstances may exist which would compel a creditor to proceed with an involuntary proceeding but such circumstances are seldom found. Nonetheless, such a threat could have impact on the conduct of the mediation.

IV. THE POTENTIAL THAT SOME OR ALL OF THE PLAINTIFF'S CLAIMS BE NON-DISCHARGEABLE IN BANKRUPTCY.

The parties in any mediation should carefully examine the plaintiff's claims to determine if any of them have the potential of being declared by a bankruptcy court to be non-dischargeable. The effect of such a declaration would be, for the most part, that

the defendant would have to deal with such claims for the rest of his life and no subsequent bankruptcy could produce a different outcome.

The categories of debt which are non-dischargeable are set forth specifically in the Bankruptcy Code (11 U.S. C. §§ 523(a)(1)-(19)). However, a specific discussion of each such category of debt is, once again, beyond the scope of this Article. Nonetheless, by way of overview, some of the types of debts specified ride though bankruptcy unaffected without any creditor action (for example, domestic support obligations; student loan obligations; tax obligations; and obligations arising by reason of violation of securities laws, just to name a few) while others require specific creditor action in the bankruptcy proceeding to prevent a discharge (for example, obtaining money, property, services or an extension of credit by fraud; defalcation while acting in a fiduciary capacity; and willful and malicious injury of another or his property).

Therefore, if one or more of the plaintiff's claims are either likely non-dischargeable or reasonably susceptible to such a declaration by the bankruptcy court, the parties should consider the following:

From the plaintiff's perspective:

The plaintiff should take the position that he either is seeking or will be seeking specific findings in the underlying litigation which will support a declaration by the bankruptcy court hat all or some of the plaintiff's claims are non-dischargeable should a bankruptcy proceeding be commenced. In this regard, the plaintiff's position should be that no discount of the plaintiff's claims which are reasonably susceptible to such a declaration by the bankruptcy court should occur due to the defendant's financial condition because, in all likelihood, the claims cannot be discharged and the plaintiff can therefore pursue those claims for the rest of the defendant's life.

From the defendant's perspective:

The defendant should take the position that the bankruptcy court is very reluctant to declare a debt non-dischargeable in that it runs contrary to the "fresh start" concept which is one of the major underpinnings of the Bankruptcy Code so that the

defendant's position should be that for that reason, "the plaintiff's claim should still be heavily discounted due to the defendant's financial condition coupled with the fact that there are and will be no identifiable assets from which the plaintiff's non-dischargeable claims could be paid even if they survive bankruptcy." In other words, the defendant's post-bankruptcy prospects are not bright and there is no present reason to believe that this projection will change.

V. CONCLUSION.

As noted in the introduction, this Article is intended to provide only an overview of potentially critical insolvency issues presented in mediating uninsured or under-insured disputes. Any party to a mediation who believes that one or more of these issues are at play is encouraged to confer with an insolvency law specialist for further analysis.